ALASKA'S 2015 STATE BUDGET CRISIS

Richard A. Fineberg, October 12, 2015 [Revised]

[At the fifth and final weekly meeting of the League of Women Voters of the Tanana Valley (LWVTV) at the Fairbanks Noel Wien Library, I introduced the following document with these comments. With about 50 people at the lecture, in response to each of the following four questions, no more than two hands were raised.]

Thank you. I am honored to be with these experts tonight. My handouts, available at the back, present a critical overview of the state's petroleum system. This overview transcends but does not focus on tonight's topic (tax credits). Therefore, I'll be brief. I have four questions for you. If you know the answers, please raise your hands. Don't worry, I won't be calling on anyone. I just want to find out how many of you are familiar with these specifics. After these questions, I'll explain their significance.

1. Have you have ever heard of a man named Archie Dunham. If you have, please raise your hands.
2. Do you know what Archie Dunham once said that might be important tonight? Raise your hands.
3. Can you define the term, "GOVERNMENT AND INDUSTRY MARGINAL SHARE"? Raise your hands.
4. Does this term refer to PRICE MINUS THE TOTAL COST OF PRODUCTION AND TRANSPORTATION, or to the smaller amount, indicating the change in the shares of the $1 dollar increase when the price of oil rises from, say, 100 to 101 dollars per barrel? Raise your hands.

In my handout -- which I have provided to the League and will be happy to give you if they are not yet posted – I will document two key points: Archie Dunham was a North Slope oil company president who once declared that his company left our state because excessive pipeline charges by the three major North Slope producers -- who also owned almost all of the Trans-Alaska Pipeline System -- took away their profits.

As for the term "marginal share:" This term was used by ConocoPhillips in a bar chart presented to the legislature six times before SB 21 was passed in 2013. That chart showed 13 bars of equal height. The state share increased from left to right on the chart, in a bright red swath that dominated those bars. As oil prices rose from $80 to $130 per barrel from left to right, the state share rose from roughly 55 percent of each bar, to more than 90 percent. Meanwhile, the industry share, in a diminishing green swath, decreased from roughly 30 percent at $80 per barrel to 10 percent at $130 per barrel. That chart was false.

Its terms were undefined, but the presenter told committees that the chart showed only the shares of the marginal $1 per barrel as prices changed. Therefore, at $130 per barrel the industry was still receiving additional revenue, which meant, among its many flaws, that the industry total share per barrel, instead of decreasing dramatically at state expense, was actually increasing.

These examples demonstrate two major points: We cannot trust the major producers who control North Slope production and TAPS. And for reasons I explain on my web site – also available for your review – for long-range planning the state needs to overhaul key elements of our petroleum revenue management system.

Thank you.

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Background Information and Views of Richard A. Fineberg
Prepared for LWVTV, October 12, 2015 *[Revised]*
(8 Supporting files attached and listed)

Because state revenues are central to our lives in Alaska, I am glad that citizens are trying to figure out what is going on with the current state budget crisis. But because this situation is extraordinarily complicated, and we need to focus on important issues. Based on decades spent reporting and working on economic and political elements of North Slope development and Trans-Alaska Pipeline System (TAPS) operations, I would like to offer these basic observations:

1. Prudhoe Bay, long in decline, was far and away the nation's largest oil field.
2. The North Slope has been extremely profitable, and these operations have historically been controlled by just three major producers. This situation, which differs radically from most other major producing oil states, has important economic consequences.
3. Economic assessment of the state's future is inherently difficult because of oil price volatility and future uncertainty, and even more difficult due to industry misinformation.
4. Although these issues are important, many of us don't seem to understand the economics and political dynamics that underlie our complicated economic decisions.
5. This lack of understanding is exacerbated by: [a] a state audit system that does not produce clear and timely information on the economics of North Slope operations; and [b] our continued struggle with a fiscal system maintained on a state basis that increases the difficulties of: (1) determining basic production costs and market data; (2) assessing corporate profitability from this unusual economic arrangement; (3) identifying global impacts on state development; and (4) spotting long-term economic trends.

The recent crash in oil prices figures prominently in current state budget policy deliberations, but the most important Alaska fiscal problems are rooted in the structure of the North Slope, where control of more than 90% of production by only three companies that also own a similar percentage of the Trans-Alaska Pipeline System (TAPS). Resulting adverse effects of this unusual consolidation of corporate economic power on the North Slope are evident in current policy debates, which are frequently confused by misunderstandings and arguments over basic economic facts. The consequences of this unique consolidation of economic power include the following three prominent aspects of current state revenue policy issues that deserve attention but seem to get lost in the confusion of this shuffle:

- chronic TAPS overcharges by the North Slope producers, handicapping competition and reducing state revenue payments;
- recent state petroleum tax cut substitution of SB 21 for ACES; and
- current implementation of those policies, characterized by the myopic approach that favors the major North Slope producers, at state expense, by [a] failure to focus on North Slope profitability and [b] failure to fix the state's chronic state audit problems.

This review suggests that in dealing with the current state budget crisis, we may be putting the cart in front of the horse. It should be remembered that the budget equation has two components -- revenues and expenditures. Their balancing is a long-term problem. Although budget cutting may be necessary, the degree to which contraction of state services has not been determined. Careful consideration should first be given to the unique aspects of the North Slope economic structure, the conduct of the major producers and state difficulties dealing with these issues.

To provide documentary support for these concerns, a brief summary of the principal articles on North Slope issues, each of which was originally posted on my web site and is available via hyperlink, can be found on the following page. (If these items are not readily accessible, please contact me to request copies by email attachment.)

Background information in support of points presented in this analysis can be found in items posted on my web site and summarized below.

The first of the two charts featured in *A Tale of Two Charts: North Slope Profitability, SB 21 and ACES* (which I first created from ConocoPhillips data in 2011 and updated for this posting on Oct. 20, 2014) demonstrates that company's remarkable North Slope profitability record. This chart indicates that even though a minor fix to ACES to deal with future oil prices higher than the prices recorded to date might have been appropriate, the Legislature's 2013 tax cut may not have been necessary. The second chart, distributed by ConocoPhillips in 2013, gave the false impression that company profits decline as oil prices increase from $80 to $130 per barrel. This misrepresentation calls for a closer look at company data and conduct. In this report, a series of three charts shows the importance of considering the cash value of total net petroleum revenues, instead of looking only at percentages of taxes on unstated quantities of petroleum production and revenues. (For documenting worksheets, see the report appendices.)[1]

To follow up on *A Tale of 2 Charts*, updating information can be found in two brief items posted in boxes on the web site home page in May and June of this year. The first of these, *7 ways Alaska could remove oil tax confusion and clarify revenue issues,*[2] posted late in May 2015, was followed by a critical review of the governor's June 2015 conference on the budget, *Oil industry profits & power omitted from budget & deficit discussions at "Sustainable Future" confab.*[3]

Each of the remaining five articles in this listing provides additional perspective on the state's current fiscal situation. *Aftermath of the SB 21 Referendum*[4] (April 8, 2015), at top left on the web site home page, contains links to other posted articles, including two background pieces on the Alaska oil and gas controversy that I prepared for presentation to panels at the 2014 and 2015 annual conferences of the Society for Applied Anthropology. On March 20, 2014, the first of these, *The Alaska Oil Tax Cut Controversy: A Case* Study[5] framed problems when the referendum debate was just getting into high gear. I updated that report a year later in the March 25, 2015 report, *Public Revenue and Extraction Profits from Alaskan Oil: An Updated Case Study*.[6] *Aftermath* also discusses *Sense, Nonsense and the Power of the Big Three,*[7] originally posted by *Alaska Dispatch*, June 21, 2014, and *The Reduced Oil Imports Report*,[8] revised edition posted Jan. 14, 2012. Additional articles on other North Slope development issues can be found on my web site.

Posted Web Site Files to Support This Analysis

Each of these reference items can be accessed from my web site home page (http://www.finebergresearch.com), or by entering the hyperlinks listed below. (To request copies by email, contact me at Fineberg@alaska.net.)

1. "A Tale of 2 Charts," Oct. 20, 2014 [revised] -- *see web site home page link at "Aftermath," paragraph 5, or enter: http://www.finebergresearch.com//pdf/Taleof2Charts.pdf.*

2. "7 ways Alaska could remove oil tax confusion and clarify revenue issues," May 27, 2015 (*Alaska Dispatch News*) -- *see box near top of home page right-hand column, or enter: http://www.finebergresearch.com/pdf/removeoiltaxconfusion150527.pdf.*

3. "Oil industry profits & power omitted from budget & deficit discussions at 'Sustainable Future' confab," June 14, 2015 -- *see second box near top of home page right-hand column, or enter: http://www.finebergresearch.com/pdf/conferenceperspective150614.pdf .*

4. "**Aftermath of the SB 21 Referendum,"** April 8, 2015 -- *see home page article at: http://www.finebergresearch.com.*

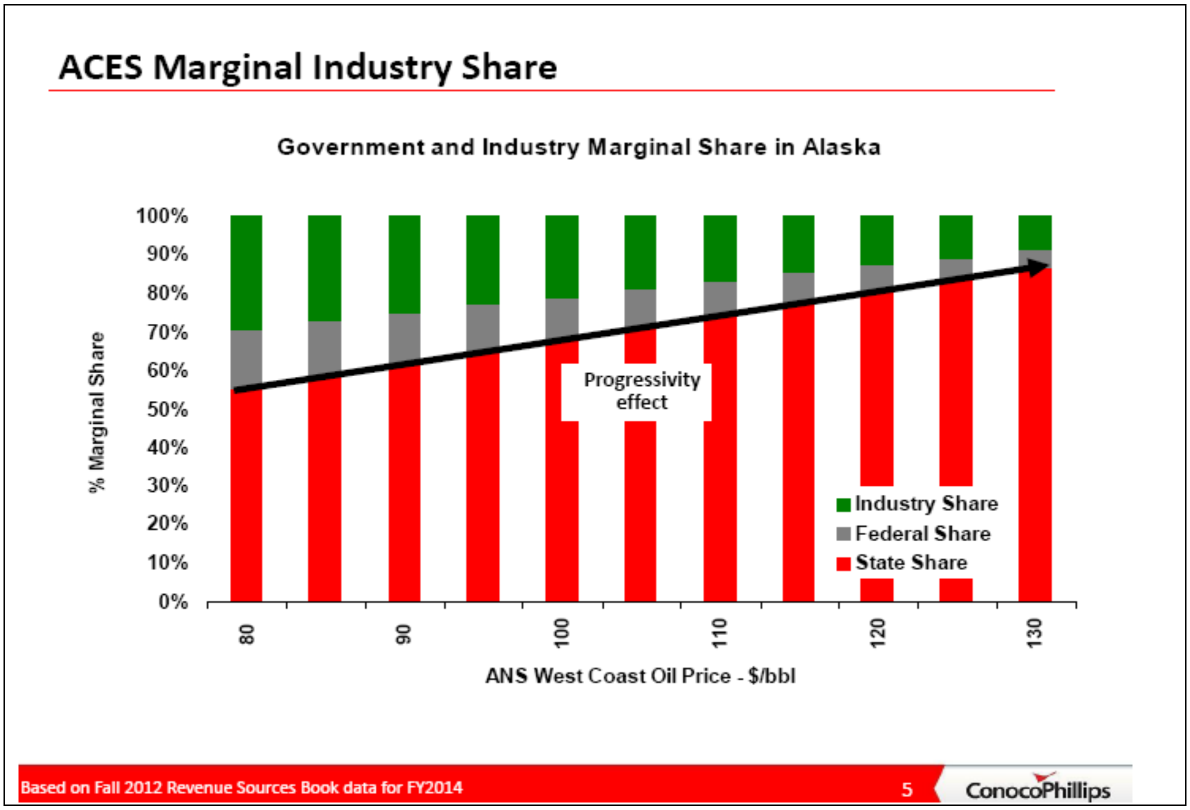
***5. "The Alaska Oil Tax Cut Controversy: A Case Study (In This Era of Information Overload, Does Our Political* System Enable Tall Tales to Triumph?),"** March 20, 2014 -- *see home page link at "Aftermath," paragraph 4, or enter: http://www.finebergresearch.com/pdf/SB21reportSfAA140320rev.pdf.*

6. "**Public Revenue and Extraction Profits from Alaskan Oil: An Updated Case Study,"** March 25, 2015 -- *see home page link at "Aftermath," paragraph 4, or enter: http://www.finebergresearch.com/pdf/Fineberg Alaskan Oil Update (Final) 150325.pdf.*

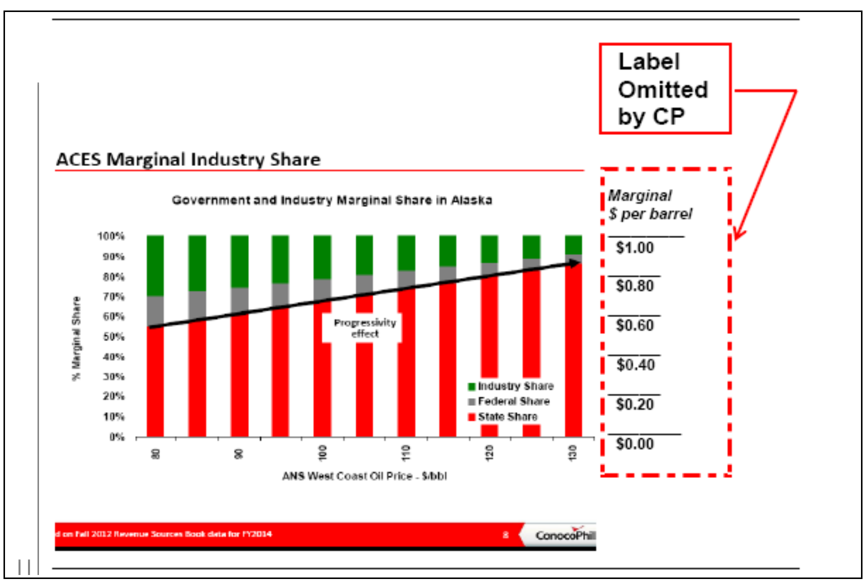
7. "Sense, Nonsense and the Power of the Big Three," June 21, 2014 (*Alaska Dispatch News*) -- *see home page link at "Aftermath," paragraph 5, or enter: http://www.finebergresearch.com/pdf/senseandnonsense140703r.pdf.*

8. "The Reduced Oil Imports Report," Jan. 14, 2012 (revised) -- *see home page link at "Aftermath," paragraph 8, or enter: http://www.finebergresearch.com/pdf/reducedoilimports111126rev.pdf.*

ConocoPhillips Chart. While SB 21 was being considered during the 2013 legislative session, ConocoPhillips included this misleading chart in a suite of slides that was presented to committees of the Alaska State Legislature on six separate occasions.



To show how easily the misimpression created by ConocoPhillips in the graphic above could have been corrected, in the right-hand margin of the graphic below I have subsequently added the label omitted by ConocoPhillips that would have corrected the company's misleading chart.



--- For additional information and data analysis, see *A Tale of Two Charts (Revised),* Oct. 20, 2014 (pp. 2-4 and worksheets 1, 2 and 3).

Why Conoco Left Alaska in January 1994. In an interview with *Hart's Oil and Gas Investor* in 1996, Conoco's Archie Dunham (who served as Conoco's Executive Vice President of exploration and production between 1992 and 1996) noted that high tariffs charged by the owners of the Trans-Alaska Pipeline System (TAPS) were the principal reason his company traded its North Slope Milne Point field to BP and left Alaska in January 1994. Dunham took over as Conoco's chief executive in 1996. When Phillips Petroleum acquired a share of TAPS in 2002, the two companies merged (form ConocoPhillips) and Dunham served as the merged company's Chairman until his retirement in 2004. Here is what Dunham told *Hart's* in August 1996:

"It broke my heart to trade Milne Point, but we had to do it. All the value of that property was taken away from us in the pipeline tariffs. It was a valuable strategic lesson – just look at why the producers in the Caspian Sea are so worried."

--- Archie Dunham (President and CEO of Conoco and later Chairman of ConocoPhillips), "Getting to the Future First," *Hart's Oil & Gas Investor*, August 1996, p. 41.

"Getting to the Future First," Interview with Archie Dunham, Chairman & CEO, Conoco, Inc. (8/96)

Hart's Oil and Gas Investor, August 1996 (copy provided by Conoco, Inc.)

GETTING TO THE FUTURE FIRST

The fact that the major TAPS owners consistently filed high tariffs on their pipeline was confirmed by court records. In 2008, Kay Cashman (Publisher and Executive Editor of *Petroleum News*) explained the problems faced by North Slope producers that did not have ownership interest in TAPS. "Until recent years," she observed, "BP, ConocoPhilips and ExxonMobil had kept tariffs (tolls) on the trans-Alaska oil pipeline high enough to keep out other oil companies, except in the form of minority interests in their North Slope fields. As a result, they controlled all the oilfield facilities and related pipelines in northern Alaska. Their production companies had to pay the same per-barrel tariff as other companies, but they could essentially get their profit back on the other end because … their pipeline subsidiaries … owned the … Alyeska Pipeline Service Co."

--- Additional documentation and data analysis on North Slope profitability and TAPS tariffs can be found in various reports at *http://www.finebergresearch.com*.